United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

74-2614

~~75-7010~~

ORIGINAL

To be argued by
EVAN L. GORDON

In The

United States Court of Appeals

For The Second Circuit

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

vs.

GEON INDUSTRIES, INC., et al., GEON INDUSTRIES, INC. and GEORGE O. NEUWIRTH,

Defendants-Appellants,

FRANK BLOOM and EDWARDS & HANLY,

Defendants-Appellees.

UNITED STATES COURT OF APPEALS
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SECOND CIRCUIT

On Appeal from the United States District Court for the Southern District of New York

BRIEF FOR DEFENDANT-APPELLEE, EDWARDS & HANLY

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UNITED STATES COURT OF APPEALS
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No. 75-7010

SECURITIES AND EXCHANGE COMMISSION,

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On Appeal from the United States District
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BRIEF OF THE APPELLEE EDWARDS & HANLY

ISSUES PRESENTED FOR REVIEW

1. Whether a large brokerage firm can be held to have violated Section 10(b) of the Securities Exchange Act

of 1934 and Rule 10b-5 thereunder when one of its registered representatives receives a call at home in the middle of the night from an officer of a corporation who instructs the registered representative to sell his stock the first thing the next morning, and conveys that such sale is based on inside information, and the registered representative upon appearing at his office complies with the customer's request and sells additional stock for his own account and other accounts as well without disclosing the reason for such sales to other office personnel.

2. Whether a large brokerage firm may be automatically enjoined in S.E.C. injunctive proceedings whenever one of its registered representatives commits a violation of the Federal Securities Laws irrespective of the firm's knowledge of the violation or participation therein.

3. Whether a large brokerage firm which institutes, maintains and enforces detailed and complete supervisory procedures over its registered representatives designed to detect prospective violations may be enjoined in S.E.C. injunctive proceedings when a registered representative commits a Federal Securities Laws violation despite the existence and enforcement of such procedures.

4. Whether, based upon the unrefuted and uncontested testimony adduced in the court below concerning: (a) the existence and enforcement of supervisory procedures; (b) the lack of knowledge of the large brokerage firm of the violations of its registered representative; and (c) the actions taken by the brokerage firm to undo the damage caused by the improper acts of its registered representative sufficient evidence was provided to justify the court's exercise of its discretion in denying injunctive relief against the brokerage firm.

ADDITIONAL STATUTES AND RULES IN ISSUE

§17(a) OF THE SECURITIES ACT OF 1933, 15 U.S.C. §77q(a):

> "(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly --
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

§15(b)(5)(E) OF THE SECURITIES EXCHANGE ACT OF 1934, 15 U.S.C. §78o(b)(5)(E):

"(E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or the Investment Advisers Act of 1940, or the Investment Company Act of 1940, or of this chapter, or of any rule or regulation under any of such statutes or has failed reasonably to supervise, with a view to preventing violations of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this clause (E), no person shall be deemed to have failed reasonably to supervise any person, if --

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with."

§20(a) OF THE SECURITIES EXCHANGE ACT OF 1934, 15 U.S.C. §78t(a):

"(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

RULE 10b-16(a)(1) OF THE SECURITIES EXCHANGE ACT OF 1934, 17 C.F.R. §240.10b-16(a)(1):

"(a) It shall be unlawful for any broker or dealer to extend credit, directly or indirectly, to any customer in connection with any securities transaction unless such broker or dealer has established procedures to assure that each customer

(1) is given or sent at the time of opening the account, a written statement or statements disclosing (i) the conditions under which an interest charge will be imposed; (ii) the annual rate or rates of interest that can be imposed; (iii) the method of computing interest; (iv) if rates of interest are subject to change without prior notice, the specific conditions under which they can be changed; (v) the method of determining the debit balance or balances on which interest is to be charged and whether credit is to be given for credit balances in cash accounts; (vi) what other charges resulting from the extension of credit, if any, will be made and under what conditions; and (vii) the nature of any interest or lien retained by the broker or dealer in the security or other property held as collateral and the conditions under which additional collateral can be required; provided, however, that the requirements of this Paragraph (a)(1) will be met in any case where the account is opened by telephone if the information required to be disclosed is orally communicated to the customer at that time and the required written statement or statements are sent to the customer immediately thereafter; and provided, further, that in the case of customers to whom credit is already being extended on the effective date of this Rule, the written statement or statements required hereunder must be given or sent to said customers within 90 days after the effective date of this Rule." [Emphasis supplied.]

RULE 52(a), FEDERAL RULES OF CIVIL PROCEDURE:

"(a) In all actions tried upon the facts without a jury or with an advisory jury, the court shall find

the facts specially and state separately its conclusions of law thereon, and judgment shall be entered pursuant to Rule 58; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses." [Emphasis supplied.]

COUNTER-STATEMENT OF THE CASE

The plaintiff-appellant Securities and Exchange Commission ("Commission") has appealed from a judgment of the United States District Court for the Southern District of New York entered on October 21, 1974, dismissing its complaint against the defendant-appellee Edwards & Hanly ("E & H"). On April 2, 1974, the Commission filed its complaint against E & H seeking a preliminary and permanent injunction against E & H from violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) and Rule 10b-5 promulgated thereunder and Section 17(a) of the Securities Act of 1933, 15 U.S.C. §77q(a), (5a-18a). Approximately six weeks later, on May 17, 1974, the Commission filed a motion for a preliminary injunction returnable on May 28, 1974 (2(a)). Upon application of the defendants, the court below ordered that a hearing take place in connection with the motion and that, pursuant

to F.R.C.P. 65(a)(2), the hearing of the motion for the preliminary injunction be consolidated with and cover the trial seeking a permanent injunction. The trial took place on June 17th, 18th, 19th, 20th, 21st and 27th, 1974 [2(a)]. That part of the proceedings which affected E & H occurred on June 21, 1974 and June 27, 1974.

A review of the transcript of the proceedings against E & H reflects that each of the witnesses called on behalf of E & H was called by the Commission with the exception of Bert G. Edwards, E & H's co-managing partner, who was called by E & H. It is also apparent from a review of the transcript, as will be more fully set forth below, that a substantial part of the information which formed the basis for the decision of the court below dismissing the complaint was premised upon information developed by the Commission on its direct examination of E & H's representatives. It is further apparent that virtually none of the facts developed at the hearing with respect to E & H were contested and thus the findings of fact of the District Court were based almost exclusively upon uncontroverted testimony.

On December 6, 1974, the appellant Geon Industries, Inc. and George Neuwirth filed a Notice of Appeal from the determination of the District Court granting an injunction

against them. Fourteen days thereafter, and only one day before the time to file a Notice of Appeal expired, the Commission filed a Notice of Appeal from the judgment dismissing the complaint as to E & H. Since E & H is not concerned with, nor does it have any part in the appeal of Geon and Mr. Neuwirth, E & H will restrict its discussion of the facts and law solely to those issues which affected the determination of the court below as to E & H and urges that this court also consider the merits of the Commission's appeal against E & H as if that appeal were brought alone and not as an apparent counterweight to the appeals of Geon and Mr. Neuwirth.

COUNTER-STATEMENT OF FACTS

Upon the Commission's statement of facts concerning the supervision of Mr. Rauch by E & H, one could not conceivably grasp the scope and extent of the case presented to the court below. It is apparent, however, that the facts concerning E & H's supervision of Mr. Rauch which were, as noted above, virtually uncontested, bear no relation to the Commission's alleged summary of the testimony given and exhibits received.

E & H established that at all relevant times it maintained detailed compliance manuals entitled A Guide for Opening and Managing Accounts for Account Executives. (E & H

Exhibit C for identification), A Guide to Supervisory Procedures for Branch Management (E & H Exhibit E for identification), A Guide to Administrative Procedures for Branch Personnel (E & H Exhibit B for identification), and A Guide to the Use and Preparation of Forms for Branch Personnel (E & H Exhibit D for identification). It was established that each registered representative has his own copy of Exhibit C (V. 703) and classes are held in the branch from time to time to review it (V. 703). These four compliance manuals, together with the active supervision of branch supervisory personnel, compliance department and other supervisory personnel, form the basis for E & H's supervisory procedures.

Martin Rosenfeld, the Manager of E & H's Hewlett Office and its Resident Partner (IV. 581) testified that he has been employed by E & H since January, 1962 and became Manager of the Hewlett Office in August, 1965 (IV. 581). Between October 1, 1973 and February 22, 1974, there were twenty Registered Representatives in the Hewlett Office under his supervision (IV. 582). Mr. Rosenfeld's duties as Resident Partner of the Hewlett Office basically include the day-to-day responsibility for compliance in the office (IV. 583).[1]

---

[1]Such supervision by a branch manager includes supervision of a registered representative's trading activities and other activities by reviewing incoming and outgoing mail, approval of all trades in discretionary accounts, reviewing blotters and monthly statements and much more (IV. 698-702) as Mr. Rosenfeld specifically testified.

When Mr. Rauch came to work for E & H, he was given a copy of Exhibit C and instructed to read it and become familiar with it (V. 704). He attended classes that Mr. Rosenfeld conducted subsequent to Mr. Rauch's retention and was monitored at least one time by the Compliance Department of E & H during his brief period of employment (V. 704). The procedure for monitoring Mr. Rauch was that three members of the Compliance Staff came to Hewlett, sat with each Registered Representative while the market was on for varying periods from ten minutes to one-half hour (V. 705) individually, and questioned him as to his manual and as to specific rules (V. 704).

At the time Mr. Rauch came to work for E & H, he told Mr. Rosenfeld that he wished to transfer from Philips, Appel & Walden because he did not wish to commute (IV. 595) and was interested in the diversity of E & H's product line (IV. 593). In order to come to work for E & H, Mr. Rauch was required to give up a higher rate of commission and certain fringe benefits which had been accorded to him at Philips, Appel & Walden (IV. 596-7). Mr. Rauch also told Mr. Rosenfeld that while he was at Philips, Appel & Walden he had accumulated an aggregate position of around 25,000 to 35,000 shares of Geon stock (IV. 600), and that his customers which he had were able to accumulate such size in

one stock because of their substantiality (IV. 601).

When Mr. Rauch came to work for E & H, Geon was not a stock permissible for solicitation by Registered Representatives of E & H because it was then selling for under $15.00 on the American Stock Exchange, although it met other requirements as to suitability prescribed by E & H's compliance rules (IV. 604). E & H had a policy requiring research department approval of any stock on the American Stock Exchange selling for under $15.00 (IV. 604). Mr. Rosenfeld, on behalf of Mr. Rauch, obtained verbal approval for solicitations of further orders probably from the first day of Mr. Rauch's employment (IV. 605). Written approval was sought and received thereafter (E & H Exhibit E, 126a).

Mr. Rosenfeld, following Mr. Rauch's employment, knew that Mr. Rauch was speaking with Mr. George Neuwirth of Geon, whom Mr. Rosenfeld later found out was the Chairman of the Board (IV. 647). Mr. Rosenfeld knew that Mr. Rauch was getting so-called "normal public relations" information on his calls to the company, i.e., that things were going well, that business was going well and matters of such a general nature (V. 712). Mr. Rosenfeld was never told by Mr. Rauch that Mr. Rauch had obtained any specific information from the company (V. 712).

The degree of supervision exercised at Edwards & Hanly was further established from the testimony of Messrs. Raleigh L. Gilbert, a partner and Bert G. Edwards, Co-Managing Partner, that they both became aware of Mr. Rauch's position in Geon in or about October, 1973 and both contacted Mr. Rosenfeld to advise him to be careful (V. 776, 777 and 788).

Thereafter, in mid-November, when Geon stock rapidly declined in price from 12 1/4 to 9 1/4 in one week (see E & H Exhibit G, 142a), Mr. Rosenfeld was given more specific suggestions by Mr. Gilbert (V. 780-781) and Mr. Edwards (V. 789) as well as by Horatio Patti, the head of Edwards & Hanly's margin department and Robert Zoellner, co-managing partner (IV. 660) that: (1) if the stock declined in value, it would have to be counted as zero in margin accounts; (2) margin accounts which contemplated further purchases must be strong enough to support themselves without Geon; (3) every order placed by Mr. Rauch for additional purchases of Geon must be approved by Mr. Rosenfeld and he should see every order ticket before it went in; and (4) he should try to get Mr. Rauch to lighten his position (IV. 660-661). This so-called "red-light" period (IV. 660) continued until the price of the stock went back to approximately the 12 - 12-1/2 dollar level and the Geon-Burmah announcement had been issued (IV. 667).

During this period of approximately three weeks, Mr. Rosenfeld approved every order ticket of Mr. Rauch for the purchase of Geon (IV. 666). During the "red-light" period (November 19, 1973) (V. 718-19) through December 3, 1973), a total of 2,750 shares of Geon were purchased by Mr. Rauch (S.E.C. Exhibit 17, 109a).

During the period of time prior to the events of February 22, 1974, there was both purchasing and selling of Geon shares by Mr. Rauch, Mr. Rosenfeld, Mr. Lynn and others (S.E.C. Exhibit 17, 109a). In fact, Mr. Lynn in the month of December sold 80% to 90% of his own and his customers' position in Geon and recommended such sale to his customers on his own because he believed that the risk-reward ratio with the stock at 13 or 14 and the deal with Burmah at $16.80 a share did not justify remaining in the stock for 2 points on the upside (V. 760). In December, Mr. Lynn sold over 2,500 shares of Geon stock (S.E.C. Exhibit 17, 109a). Mr. Rauch also sold during this period of time including a 2,000 share sale for a customer on January 23, 1974 (S.E.C. Exhibit 17, 109a).

When Mr. Rauch arrived at the office on the morning of February 22, 1974 following the call from Mr. McMahon at his home at 1:30 a.m., Mr. Rauch gave no indication whatever to either Mr. Rosenfeld or Mr. Lynn during

the course of the trading day on February 22 that he had any idea as to why the opening was delayed, why there was an imbalance of orders or why trading had been suspended (IV. 687-693 and V. 755-756). In fact, Ivan Boesky, E & H's Arbitrage Partner, called Mr. Rauch on February 22 and became angry at him for failing to sell to Mr. Boesky the shares he was in fact selling (V. 833-34). Mr. Boesky purchased 4,000 shares of Geon from Mr. Rauch for the Arbitrage account following his first conversation with Mr. Rauch when Mr. Boesky became angry (V. 835).

On March 4, 1974 after hearing of the alleged insider trading, E & H broke all of the alleged insider trades and restored the stock to the respective accounts (E & H Exhibit J, 148a, V. 791). Moreover, with respect to the remaining sales out of the Hewlett Office on February 22, E & H broke the street-side of the trades and absorbed 3,000 shares into its error account (E & H Exhibit K, 158a, V. 786).

E & H, therefore, did not earn any commissions on the sales of February 22 (see E & H Exhibit J, 148a), but sustained a loss of approximately $12,500 on the 3,000 shares taken into its error account when they were sold at a price of 9-7/8 shortly after trading in Geon resumed (V. 796-797). Moreover, Mr. Rauch was discharged by E & H

(E & H Exhibit I, 146a) following definitive proof of his wrongdoing.

ARGUMENT

POINT I

BASED UPON THE UNCONTESTED FACTS DEVELOPED AT TRIAL E & H UNQUESTIONABLY EXERCISED ADEQUATE SUPERVISION OVER THE DEFENDANT RAUCH

All of the facts set forth above and others were found by the District Court to prove that E & H "acted in good faith and that the evidence fails to establish that Edwards participated in or knew of Rauch's misconduct or that Edwards did not exercise reasonable supervision over Rauch." 381 F. Supp. at 1071. It is respectfully submitted that this finding of the District Court is overwhelmingly substantiated and thus is unquestionably correct.

It is of course established that review of District Court findings of fact in S.E.C. injunctive actions is governed by the "clearly erroneous" rule which requires that the reviewing Court affirm the findings of the District Court unless the reviewing Court believes that the facts were without adequate evidentiary support in the record or were induced by an erroneous view of the law. The

burden of showing that the findings are clearly erroneous is on the one attacking them. See S.E.C. v. Continental Tobacco, 463 F.2d 137, 156-7 (5th Cir. 1972), Rule 52 F.R.C.P. In the instant case, the findings of fact were so clearly correct, based as they were on uncontradicted testimony, that the Commission cannot seriously argue that they were clearly erroneous.

The Commission's attack upon the findings of the court below is premised upon a misapprehension of the facts presented to the District Court, and, in certain respects, upon a distortion of the record. For example, the Commission alleges that Mr. Lynn testified that Mr. Rauch's file on Geon contained information which Mr. Lynn did not believe was available generally (Brief, p. 24) and that, therefore, Mr. Lynn suspected that Rauch had amassed inside information on Geon (Brief, p. 33). However, Mr. Lynn's testimony was:

> "If I wanted to know something about Geon, I would speak to Mr. Rauch because he had an extensive file of material on the company. Something I had never seen before. I didn't believe there was that information published by a company."

The foregoing testimony in no way even remotely supports the Commission's statement that Mr. Lynn suspected that Mr. Rauch had anything other than published information, since Mr. Lynn's statement was obviously that he did not know so much published information was available.

The Commission further alleges that on February 22, 1974 both Mr. Rosenfeld and Mr. Lynn followed Mr. Rauch's example of selling, allegedly contributing to the imbalance of sell orders, driving down the market price of Geon's common stock (Brief, p. 24). In fact, as noted above, Mr. Lynn had sold out between 80% and 90% of his own and his customers' position in December (supra, p. 13).

Mr. Lynn on February 22 sold only 500 shares of Geon in four separate accounts (116a) and Mr. Rosenfeld only sold 1,200 shares in three separate accounts, Id. When queried at the trial as to the reasons for his sales on February 22, Mr. Rosenfeld testified that he sold his shares between 10 and 15 minutes after the opening and recommended that certain of his customers sell their shares because he did not like the way the stock was trading (IV. 690-691). Mr. Rosenfeld specifically testified that he did not sell upon the basis of any information given to him by Mr. Rauch (V. 714-715).

The Commission also alleges (Brief, p. 26) that Mr. Gilbert allegedly forbade further solicitation of the purchase of Geon stock. The Commission utterly distorts the nature of the testimony by then alleging that Mr. Rosenfeld violated the admonition by permitting Mr. Rauch to continue soliciting purchases of Geon common stock (Brief, p. 26).

However, as noted above, initially Mr. Gilbert merely asked Mr. Rosenfeld if he was aware of the accumulation and thereafter, when the price declined, gave more specific suggestions (the "red light" period). However, Mr. Rosenfeld permitted Mr. Rauch to continue to solicit purchases of Geon during the so-called "yellow light" period (IV. 659) and not during the "red light" period (IV. 660-663). Thus, the Commission's apparent position that Mr. Rosenfeld violated internal E & H requests is utterly unsupported and false. It was established moreover that the so-called "red light" period commenced on or about November 19, 1973 (V. 718-719) and thus the Commission's contention that certain purchases were made in violation of the "red light" suggestions is again totally unsupported (Brief, p. 27).

The Commission has persisted moreover in attempting to convince the court that somehow Mr. Rauch was given privileges not available to other registered representatives (Brief, pp. 27-28). Much is made of an alleged procedure to telephone orders to the main wire room, so-called "special handling". However, in the court below, there was specific testimony that the so-called "special handling" of an order is done routinely on orders of any substantial size in order to secure best execution for the customer (V. 721-722). Thus, even by innuendo, the Commission did not establish in

the court below any irregularity in connection with the treatment accorded to Mr. Rauch by E & H. Moreover, as noted above, Mr. Rauch gave up substantial fringe benefits when he left Philips, Appel & Walden and came to work for E & H which is exactly contrary to any alleged special treatment (see p. 10, <u>supra</u>).

The Commission also alleges that certain irregularities apparently occurred in accounts maintained by the defendant McMahon and Louis Maione, his father-in-law (Brief, pp. 11-12 and 40). The Commission criticizes E & H's policy that a new account card had to be completed for each customer and approved by the manager or assistant manager, because the customer was not required to sign the card or present himself at E & H in connection with the opening of a new account (Brief, p. 39). Indeed the Commission even criticized E & H's reliance upon the integrity of its registered representatives with respect to the information set forth on a new account card and criticizes the fact that a margin account may be opened without a signed agreement in advance, <u>Id</u>. It is alleged that the "superficiality" of E & H procedures permitted Mr. McMahon to open an account with false information as well as to permit the opening of the Maione account (Brief, p. 40).

However, it was established at trial that E & H's

own compliance manual requires the individual registered representative to obtain the information for the firm's new account report and its supervisory manual requires a branch manager to spot-check the accuracy of the information provided in the new account report (IV. 615). These procedures are concurred in by the Report of the Advisory Committee on a Model Broker-Dealer Compliance Program ("Model Manual") of January 1974, a manual prepared by brokerage firm counsel, counsel to the New York and American Stock Exchanges, counsel to the National Association of Securities Dealers, Inc. and a representative of the Securities and Exchange Commission. The Model Manual states as sufficient compliance that: "the supervisory person must see that the salesman obtains whatever facts are appropriate in each case," Chapter IV, p. 5. (Emphasis supplied.)

Under E & H's procedures, the registered representative not only fills out the new account card, but, with respect to supporting documents, makes an entry on the card that the documents are in-house, or will shortly be obtained. The registered representative then signs the new account card (see, e.g., S.E.C. Exhibits 18 and 19, 117a-119a). Under E & H's procedures, the signature of a registered representative on the new account card constitutes a certification by the registered representative that the

information is true and correct and that the papers which are required are, in fact, being obtained (IV. 623 and V. 710).

In the case of the McMahon and Maione accounts, the Commission complains that there was a deliberate falsification of Mr. McMahon's employment status (Brief, pp. 12 and 40). Under the spot-checking procedures, it is not known whether the McMahon account was spot-checked, but in view of the fact that Mr. McMahon himself ordered the falsification, which had originally been instituted when the account was opened at Philips, Appel & Walden, it is hard to see how E & H can be held liable if a customer deliberately chooses to defraud the broker.

The McMahon account with E & H was transferred from Philips, Appel & Walden (i.e., from Loeb Rhoades & Co., Philips, Appel & Walden's clearing broker) (V. 711). Indeed, Mr. Rosenfeld, at the time the McMahon account was opened with E & H, testified there were approximately between 75 and 100 other accounts being transferred at the same time and there was a single period of time when all of the new account forms were physically written up and handed to Mr. Rosenfeld for signature (V. 711). Mr. Rosenfeld did some spot-checking with respect to some of these transferred accounts (V. 712). The mere fact that the McMahon account

may not have been one of those spot-checked or that there was false information is hardly a basis for claiming that E & H violated the Federal Securities Laws.

Between October 18, 1973 and February 22, 1974, a total of 100 shares of Geon were purchased in the McMahon account and 600 shares were purchased in the Maione account (S.E.C. Exhibit 17, 109a). During the same period of time, Mr. Rauch had accumulated in excess of 60,000 shares for himself and his customers (including the shares transferred from Philips, Appel & Walden) (V. 722). Nonetheless, the Commission persists in attempting to impose injunctive relief upon Edwards & Hanly on the basis of the alleged activity in these two accounts despite their totally inconsequential nature.

It is alleged in connection with the Maione and McMahon accounts that margin agreements were not signed until some time after the opening of the accounts (Brief, p. 39). The Commission alleges that it is a lax procedure not to require a margin agreement prior to the execution of trade in a margin account, despite the existence of Rule 10b-16 of the Securities Exchange Act of 1934, 17 C.F.R. §240.10b-16, which recognizes that margin accounts are frequently opened on the telephone.

Similarly, the Commission persists in contending

that it is a violation of some supervisory procedure for E & H to fail to require that a customer physically come to E & H's offices and/or physically sign his new account card (Brief, p. 39). However, the Model Manual again places the burden on the supervisory person to "have a system of follow-up to be sure that such documents (legal documents needed to evidence that maintenance of the account is properly authorized) are received within a reasonable period or the account is restricted from further business," see Chapter IV, p. 9. The Model Manual does not place restrictions that a new account card has to be signed, that accounts cannot be opened on the telephone or that all papers must be in-house prior to the execution of any trade.

Although the margin agreement in the McMahon account was not received until December 24, 1973 (E & H Exhibit A, 124a), there is no basis for contending that there is anything improper about the time lapse because the remedy for failing to receive documents is, under E & H procedures and the Model Manual, to restrict the account from further business. The only evidence of trades in the McMahon account before the court between August and December, 1973 is the purchase of 100 shares of Geon on October 22, 1973 (S.E.C. Exhibit 17, 109a). Therefore, the single isolated transaction in no way supports any contention that E & H could have used the

pretense of the absence of a margin agreement to do anything with respect to restricting Mr. McMahon's account since there was no further activity in the account to restrict.

Similarly, the only transactions in the Maione account from its opening on November 1, 1973 (S.E.C. Exhibit 19, 119a) and the date of the receipt of the margin agreement on January 31, 1974, were the purchase of 600 shares of Geon on November 2, 6 and 9, respectively (S.E.C. Exhibit 17, 109a). Therefore, again, E & H cannot be charged with any violation, since clearly transactions within a week of opening an account are well within a reasonable time and there was nothing thereafter to restrict for failure to obtain an agreement.

Mr. Maione testified that he had authorized Mr. McMahon, his son-in-law, to open a brokerage account in Mr. Maione's name to buy Geon (V. 771-772). Mr. Maione confirmed that he received statements from E & H as to the trades, which he did not bother to examine, but instead gave them to his son-in-law (V. 773). He never called anyone at E & H to ask why he was receiving statements (V. 773). Accordingly, there is no basis on which the Commission can contend that E & H was placed on notice of any alleged irregularities in the Maione account and moreover, no basis on which such irregularities in and of

themselves can be shown to constitute a violation of the Federal Securities Laws.

Finally, the Commission contends (Brief, p. 28) that there were no guidelines of E & H concerning contacts between representatives of the firm and officers and directors of publicly traded companies. Such a contention distorts the record. Mr. Rosenfeld testified that prior to March 1974, when the procedures were clarified (IV. 643), Branch Manager approval with respect to contacting officers, directors or employees of the companies were required (IV. 642). Prior to March 1974, there were, moreover, written regulations prohibiting a registered representative from contacting a company representing himself as E & H, an investment advisor or an analyst (IV. 643).

From all of the foregoing facts, it is apparent that there was a more than adequate basis for the court below to find that E & H had exercised reasonable supervision over Mr. Rauch, that it was not liable for his violations, and that by virtue of such supervision, it was not itself in violation of the Federal Securities Laws. As noted above, it is respectfully submitted that these findings, supported as they are by substantial and unrefuted evidence, are clearly correct and should not be disturbed upon appeal.

POINT II

THE IMPOSITION OF AUTOMATIC LIABILITY UPON E & H FOR IMPROPER ACTS OF ITS SALESMAN, MR. RAUCH, IS CONTRARY TO STATUTE, CASE LAW, FUNDAMENTAL FAIRNESS AND COMMON SENSE

Faced as it is with the foregoing uncontested factual evidence, and the findings of the court below in accordance with that evidence, the Commission seeks to avoid what has been and self-evidently will be a determination that E & H is not liable under the facts of this case for failing to supervise Mr. Rauch by alleging a theory of so-called "respondeat superior" under which the Commission contends that E & H is automatically liable for the wrongful acts of Mr. Rauch. This simplistic theory of automatic liability, however, is not only contrary to statute and case law, but offends all sense of fundamental fairness and is thus contrary to common sense.

The Commission's theory of automatic liability utterly ignores certain essential provisions of the Securities Exchange Act of 1934 which self-evidently control. Section 15(b)(5)(E) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(b)(5)(E), provides that the Commission has the power to deny, suspend or revoke the registration of a broker-dealer if the broker-dealer:

"(E) has willfully aided, abetted, counselled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or the Investment Company Act of 1940, or of this title, or of any rule or regulation under any of such statutes or has failed reasonably to supervise, with a view to preventing violations of such statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this clause (E) no person shall be deemed to have failed reasonably to supervise any person if --

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with."

As is apparent from the language of the foregoing section, a broker-dealer's obligation to reasonably supervise one of its employees is not dependent upon whether the employee commits a violation but whether procedures have been established which would reasonably be expected to detect a violation and whether those procedures were carried out in a specific case without reasonable cause to believe that the procedures were not being complied with. This section unquestionably constitutes a congressional declaration of policy as to what conduct on the part of a broker-dealer with respect to supervision is considered to violate

the Exchange Act. It is also apparent that this provision is specifically intended to obviate a theory that a broker-dealer is liable in an S.E.C. enforcement proceeding for the acts of a registered representative on theory of "principal-agent" or "respondeat superior" which imposes absolute liability for any wrongful act of a registered representative.

It is, of course, apparent that Section 15(b)(5)(E) by its terms applies only to administrative proceedings. However, in the absence of a clear Congressional intent to the contrary, it is equally apparent that the policy determinations underlying the provision should apply equally to injunctive proceedings and there is no rational reason why the standard embodied in that section should not apply with equal force in any enforcement proceeding.

Indeed, the hearings conducted prior to the enactment of this section in 1964 contain evidence that Congress was aware of the unfairness of a theory which holds a broker-dealer strictly responsible for all unlawful acts of one of its employees. In testimony before the House Subcommittee on Interstate and Foreign Commerce, the then Chairman of the Securities and Exchange Commission, William F. Carey, testified:

"At the present time, if an individual connected with a securities firm violates the law without the approval or knowledge of his employer, the Commission can take disciplinary action only by a proceeding against the entire firm. This approach possibly involves many persons wholly innocent of the violation in question, is awkward and may be unfair."

Hearings Before the Subcommittee of the Committee on Interstate and Foreign Commerce on HR 6789 and 6793 and S. 1642, 88th Cong. 1st Sess. (November 19, 1963), 111 at p. 129. Indeed, the House Report on Section 15(b)(5)(E) specifically notes that that section provides "that no person shall be deemed to have failed reasonably to supervise another person if appropriate supervisory procedures and system exist and the supervisory person involved has reasonably discharged his duties under those procedures and system and has no reasonable cause to believe that the procedures and system were not being complied with", House Report No. 1418, Interstate and Foreign Commerce Committee, Accompanying HR 6793 (May 19, 1964) cited in 2 U.S. Congressional and Administrative News, 88th Congress, 2nd Session, page 3034 (1964).

There appears to be only one reported case dealing with the relationship between Section 15(b)(5)(E) and the abstract legal theory of automatic liability. In Armstrong Jones & Co. v. S.E.C., 421 F.2d 359 (6th Cir. 1970), the

Court mistakenly held that Section 15(b)(5)(E) of the Exchange Act is complementary to the doctrine of _respondeat superior_, 421 F.2d at 362. The Court apparently premised its ruling upon the Commission's contention contained in its brief that when the legislation was proposed in 1963 the Commission advised the Senate that Clause (E) "would not limit the existing power of the Commission to discipline a broker or dealer firm under the doctrine of _respondeat superior_ for any violation by a person associated with such broker or dealer." _Technical Statement of the Securities and Exchange Commission Relating to S. 1642. S.E.C. Legislation 1963, Hearings Before a Subcommittee of the Committee on Banking and Currency United States Senate_, 88th Congress, 1st Session 352 at 363-364 (1963). However, the complete text of the statement concerning the above subject matter clearly indicates that the Commission in fact recognized that enactment of Section 15(b)(5)(E) obviated any claim of automatic liability on the part of a broker-dealer.[2]

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[2] The complete text reads as follows:

> "This amendment also provides that no person shall be deemed to have failed reasonably to supervise another person if appropriate supervisory procedures and system exist and the supervisory person involved has reasonably discharged his duties under those procedures and system and has no reasonable cause to believe that they were not being complied with. _A supervisory employee is, therefore, not an absolute_

It is respectfully submitted, moreover, that Section 15(b)(5)(E) supersedes and nullifies prior Commission administrative decisions applying the doctrine of _respondeat superior_ and establishes a new standard for the regulation of the conduct of broker-dealers. Moreover, more recent Commission administrative decisions sustaining _respondeat superior_ do not in the least explain the apparent inconsistency between Section 15(b)(5)(E) and the theory of _respondeat superior_.

Moreover, the application of a doctrine of _respondeat superior_ makes no sense in the context of the

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(footnote con't)

> _guarantor of the conduct of those whom he has the power to supervise_. Thus, for example, if a branch manager has established appropriate procedures (and an appropriate system for applying them) for supervising the personnel of his office and appropriately discharges his own responsibilities without reasonable cause to believe that such procedures and system are not being followed, he is not responsible, even if notwithstanding these precautions, one of his employees violates. Similarly, partners in the home office of a firm would not be responsible for violations in a branch office if appropriate supervisory procedures (and an appropriate system for applying them) for the branch office have been established and the partners have reasonably discharged their own duties and have no reason to believe that the established procedures and system were not being followed. It would, however, be the responsibility of managing partners to see to it that appropriate procedures and system are established and observed.
>
> Proposed clause (E) would not limit the existing power of the Commission to discipline a broker or dealer firm under the doctrine of respondeat superior for any violation by a person associated with such broker or dealer." (Emphasis supplied.)

Commission's enforcement objectives. In essence, the Commission is alleging that every broker-dealer is liable for every wrongful act of one of its employees. If such were the case, every broker-dealer of any substantial size would necessarily within a short time after opening for business incur liability for its salesmen's acts. It is, of course, impossible for a brokerage firm of any size to prevent a wrongful act from occurring. Therefore, the Commission is, by advancing a theory of respondeat superior, essentially arguing that every broker-dealer as a condition of engaging in business assumes an insurer's liability for any act of its employees. The imposition of such an obligation is self-evidently nonsensical because: (1) the effectiveness of an injunction as an enforcement tool would be destroyed by such a routine application, and (2) the federal courts would be inundated with contempt of court citations against virtually every brokerage firm on a regular basis. Although such a condition may theoretically be within the power of Congress to order, it is respectfully submitted that the practical implications of such a policy

require legislative rather than judicial determination.[3]

The Commission places its primary reliance for its contention that absolute liability applies upon the recent decision of this court in S.E.C. v. Management Dynamics, Inc., ____ F.2d ____ , C.C.H. Fed. Sec. L. Rep. par. 95,017, p. 97,562 (2nd Cir. 1975). Management Dynamics dealt with the relationship between Section 20(a) of the Exchange Act and *respondeat superior* and did not discuss the applicability of Section 15(b)(5)(E).

The court's discussion of the relationship between Section 20(a) of the Exchange Act and *respondeat superior* will be discussed further below, but it should be noted at the outset that in its decision, this court held a brokerage firm liable for the activities of its vice president in charge of trading, and found that the vice president exercised apparent authority on the brokerage firm's behalf. However, the court specifically noted:

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[3] It should be noted that one commentator agrees that the proper standard should be the duty to supervise and not the "oppressiveness which inheres in the S.E.C.'s theory of respondeat superior liability." Comment, The Burden of Control: Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934, 48 N.Y.U. Law Review 1019 at 1038-39 (November, 1973).

"We stress again, however, that we intimate no view as to other cases which may involve lesser employees, actions for damages, agency principles, or respondeat superior which may be broader than the apparent authority involved here. Such cases may involve entirely different policy considerations that are best consigned to future resolution."
F.2d at , C.C.H. at p. 97,571.

From the foregoing, it is apparent that Management Dynamics avoided creating a precedent for the type of situation present in the instant case. Unlike a vice president with apparent authority to act for a firm, the Commission seeks to impose absolute liability upon a large member firm for the activities of one registered representative in one of many branch offices. As set forth above, the policy considerations referred to by this court in Management Dynamics clearly mitigate against the imposition of such liability.

The court below in ruling that the appropriate legal standard for determining E & H's liability was that it adequately supervised Rauch, did not rely upon Section 15(b)(5)(E), but relied instead upon the case of S.E.C. v. Lum's, Inc., 365 F.Supp. 1046 (S.D.N.Y. 1973), which specifically held that in an S.E.C. injunctive proceeding, the proper standard for determining whether a broker-dealer is liable for the acts of a registered representative is that contained in Section 20(a) of the Exchange Act, and not

upon the so-called theory of respondeat superior. The decision in Lum's did not apply the principles of Section 15(b)(5)(E) and the statute was not even discussed.

It is respectfully submitted, however, that the principles of Section 20(a) create a general frame for liability under the Exchange Act as will be more fully discussed below. Further, Section 15(b)(5)(E) refines the principles of Section 20(a) and specifically applies those principles to the liability of broker-dealers in S.E.C. proceedings. Thus, E & H contends that the proper standard for its liability is that imposed by Section 20(a) as qualified and restricted by Section 15(b)(5)(E).

In its decision in Lum's, the District Court gave persuasive weight to legislative history surrounding the enactment of Section 20(a) and concluded from that history that principles of automatic liability were specifically intended to be excluded as a means of imposing liability under the Exchange Act. The reasoning of the District Court in Lum's was also followed by the United States District Court for the Northern District of California in the case of Jackson v. Bache & Co., Inc., 381 F. Supp. 71 (N.D. Cal. 1974). In that case, the court observed that:

> "To superimpose agency law over Section 20 would be to create a strict liability standard - a standard specifically rejected by Congress when

> Section 20 was adopted. Compare the Senate's proposed standard of 'i[illegible]r's liability' (S. Rep. 47, 73 Cong. 1st [illegible] (1933)) with the position of the House [illegible]s finally adopted (H.R. Rep. No. 1383, 73 C[illegible]. 2d Sess. 5). Since Section 20's broad defini[illegible]on of control would always include those liable under respondeat superior theory if agency principles were adopted, the good faith defense specifically contained in Section 20 would be emasculated." 381 F. Supp. at 95.[4]

In the instant case, the defendant Rauch, a minor employee, was unquestionably acting in his own behalf and directly contrary to the rules and regulations established by E & H. It is also clear that in so acting, Rauch misled E & H so that they would not discover his wrongful conduct. Under these facts, E & H contends that this court's decisions in Gordon v. Burr, 506 F.2d 1080 (2nd Cir. 1974), and Lanza

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[4] E & H is, of course, aware that this court in Management Dynamics disagreed with the exposition of legislative history set forth by the respective courts in Lum's and Jackson. However, E & H believes that the legislative history relied upon by the court in Management Dynamics was prior legislative history to that relied upon by the other courts. Moreover, the legislative history relied upon by the court in Management Dynamics concerned the proposed Section 15 which did not incorporate the language in Section 20 as subsequently enacted that: "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." It appears that the foregoing additional language was only adopted in later drafts proposed as more fully set forth by the courts in Lum's and Jackson; see also, Comment, Brokerage Firm Liability for Salesman's Fraudulent Practices, 36 Fordham Law Review, 95, 96 (1967).

v. Drexel & Co., 479 F.2d 1277 (2nd Cir. 1973) more closely approximate the nature of the relationship between Rauch and E & H with respect to the conduct alleged and should be followed insofar as they refuse to impose liability upon an employer or outside director in the absence of a showing of bad faith or direct or indirect inducement of the violations alleged.

The Commission's reliance, moreover, upon cases involving the imposition of liability for damages are clearly inapposite. Johns Hopkins University v. Hutton, 422 F.2d 1124 (4th Cir. 1970), Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973), and Fey v. Walston & Co., 493 F.2d 1036 (7th Cir. 1974) all involve the question of whether, with respect to a third party, an officer or registered representative of a brokerage firm could commit acts in the normal course of his employment which could expose the brokerage firm to monetary liability. The policy considerations underlying such a determination, to wit, the obligation of a brokerage firm to make financial restitution to customers wronged by acts of its employees is not present in the instant S.E.C. injunctive proceeding. Indeed, such an issue could never be present in this proceeding because, as noted above, E & H not only broke all of the alleged insider trades and restored the stock

to the respective accounts, but also broke the street-side of the remaining trades in Geon on February 22 out of the Hewlett Office and absorbed the shares in its error account (see p. 14, supra). Thus, even adopting the view of the foregoing courts in private actions with which Jackson, supra, expressly disagrees, it is apparent that on the facts of this case, no liability could be found.

Similarly, S.E.C. v. Rapp, 304 F.2d 786 (2nd Cir. 1962) and S.E.C. v. Charles A. Morris & Associates, Inc., 72-73 C.C.H. Sec. L. Rep. ¶93,756 (W.D. Tenn. 1973), cited at page 34 of the Commission's Brief involved affirmative acts by the broker or active participation by corporate officers in the schemes involved. In the instant case, no such involvement was alleged, much less proved.

From all of the foregoing, it is apparent that the imposition of absolute liability is sought by the Commission under the misnomer of "respondeat superior". While giving the Commission an easy victory in this case, the imposition of such automatic liability would disserve the brokerage community and is contrary to statute and case law. Moreover, as was noted at the time of enactment of Section 15(b)(5)(E), the imposition of such automatic liability would be palpably unfair and if assessed should be assessed only by Congress and in no event be legislated by this court.

POINT III

E & H DID NOT AID AND ABET THE VIOLATIONS OF DEFENDANT RAUCH

The Commission takes issue with the finding of the court below that E & H did not participate in or know of Rauch's misconduct (Brief, p. 37). The Commission relies upon this court's decision in S.E.C. v. Spectrum, Ltd., 489 F.2d 535 (2nd Cir. 1973) which held erroneous a finding of the court below that one cannot be an aider and abettor unless he actually knows of the improper scheme and intends to further it, 489 F.2d at 541. The court in Spectrum held that a negligence standard is sufficient.[5]

The Commission, however, fails to allege the manner in which it claims a negligence standard should be applied against E & H upon the facts of the instant case. E & H contends that in order to aid and abet Rauch, it, therefore, must know of the violative conduct or have reason

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[5] It should be noted that the promulgation of a negligence standard for aiding and abetting is contrary to long-established precedent requiring a purposeful participation in the violative conduct. See III Loss, Securities Regulation, at 1476; see also Ruder, Multiple Defendants in Securities Law Fraud Cases, 120 U. of Penn. Law Review, 597 at 638 (1972).

to know of it and failed to take steps to prevent it; see Brennan v. Midwestern United Life Insurance Co., 259 F. Supp. 673 at 681 (N.D. Ind. 1966), S.E.C. v. Manor Nursing Centers, 340 F. Supp. 913 at 933-934 (S.D.N.Y. 1971), reversed in part on other grounds, 458 F.2d 1082 (2nd Cir. 1972).

In support of its position that E & H should have known of the violative conduct, the Commission relies upon innuendo and in some respects upon a distortion of the record. It alleges that Mr. Rauch was given preferential treatment, although the relevance of such a contention to the violations alleged is unestablished, even if true. The Commission also takes issue with the Model Manual and various rules and regulations (see pp. 20-23, supra), in questioning the manner in which E & H opened accounts, obtained the necessary legal papers and trusted the integrity of its registered representatives. Moreover, the Commission utterly distorts the record in trying to accuse Mr. Rosenfeld of failing to follow firm instructions concerning future purchases of Geon (see pp. 17-18, supra).

As a last unfortunate attempt to create liability where none exists, the Commission seeks to distort the quality and quantity of the evidence submitted to the court below. It alleges that because the manuals were not admitted into evidence, the court below could not consider the fact

that they existed (Brief, pp. 41-42) (although there was testimony to that effect) (V. 697-698, 702-704) and there was even significant testimony as to the contents of the manuals and the way in which the dictates of the manual were performed at the Hewlett office (V. 697-705).[6] The Commission's disingenuous argument appears to be that because the court declined to read the manuals, it could not rely upon E & H's testimony as to their contents.

The Commission further contends (Brief, pp. 41-42) that E & H did not provide sufficient detail at the hearing as to the classes given, the Compliance Department's monitoring of Mr. Rauch, or the specific subject of classes given by Mr. Rosenfeld. Obviously if the Commission had deemed such enormous amount of detail to be relevant at the time, it could have elicited the information from the respective witnesses. It clearly did not do so because the Commission well knows that the presentation of such a mass of detail was not necessary for the court to find the existence of adequate supervision. Thus, the Commission's exaggerated

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[6]It should be noted that the Commission was provided with copies of these manuals following the trial and prior to submission of post-trial memoranda and had the opportunity to comment on the manuals had it desired to do so. Thus, had the Commission found anything in the manuals inconsistent with the testimony adduced at trial, it presumably would have called the court's attention to such inconsistencies.

conclusion (Brief, p. 42) that E & H did not perceive what true compliance with the Securities Laws entailed insofar as it relates to supervision of sales personnel, is so far beyond the uncontested evidence submitted to the court below upon which it premised its findings, as to be ridiculous.

Based upon all of the foregoing facts and circumstances, it is apparent that E & H did not know, nor could it reasonably have been expected to know of Rauch's violative conduct. Indeed, in the more than one year that this litigation has been pending, the Commission has never satisfactorily explained what a broker is supposed to do to prevent a registered representative from receiving a call at home in the middle of the night and coming into the office the next morning and acting improperly upon that call, where the registered representative conceals the facts from his employer. It is respectfully submitted that until and unless the Commission can rationally answer this question, that the Commission's entire case is premised upon a basic and fundamental irrationality.

POINT IV

THE DISTRICT COURT CORRECTLY RULED THAT INVESTIGATIVE TESTIMONY OF MR. RAUCH COULD NOT BE ADMITTED AGAINST E & H

The Commission's argument with respect to the

admissibility of investigative transcripts of Mr. Rauch appears to lack one fundamental element, to wit, what specific testimony in those transcripts is contended to be adverse to the interests of E & H. Indeed, E & H objected to the introduction of these transcripts in the court below only because of certain unclear references in the transcripts which E & H would not have had the opportunity to clarify upon cross-examination. Further, even if it is assumed that in some unknown way Rauch's testimony was inconsistent with the testimony given by E & H's representatives, it is apparent that the transcripts were inadmissible.

The transcripts in question were taken on March 5 and March 7, 1974, respectively, in private conference at the Commission's offices. In addition to representatives of the Commission and the witness Rauch, only Rauch's personal attorney was present. The defendant E & H was not represented and, as will be shown below, could not have been represented in these proceedings.

Rule 7(b) of the Commission's rules relating to investigations, 2 C.C.H. Fed. Sec. L. Rep. par. 66,233, Reg. 203.7, p. 59,103, provides that any person who appears at a formal investigative proceeding may be accompanied by counsel provided, however, that all witnesses shall be sequestered and that unless the officers conducting the

examination consent, no witnesses or counsel accompanying such witnesses shall be permitted to be present during the examination of any other witness called in such a proceeding. The Commission has uniformly interpreted this rule so as to prohibit counsel for a brokerage firm from being present at the interrogation of one of its registered representatives, unless counsel represents the registered representative in his individual capacity as well. E & H's counsel could not represent Mr. Rauch because of factors established before the court below. Therefore, E & H's counsel, had they appeared, would have been excluded from the proceeding.

By virtue of the foregoing, had the transcripts in question been received in evidence, E & H would have been unable to cross-examine Rauch. It is respectfully submitted that a failure of a right of cross-examination in and of itself made the transcripts inadmissible and the court below so ruled, observing that to admit the transcripts without the right of cross-examination might be unfair (V. 842-843).

The provision embodying this principle of fundamental fairness is contained in Rule 32(a) of the Federal Rules of Civil Procedure regulating the use of depositions and is also contained in Rule 804(b)(1) of the Federal Rules of Evidence. Rule 32 provides <u>inter alia</u> that any part or

all of a deposition may be used against any party who was present or represented at the taking of the deposition. Rule 804(b)(1) similarly provides that testimony given as a witness at another hearing may not be offered unless an opportunity is given to the party against whom the testimony is offered to develop the testimony by cross-examination. A deposition cannot be used as substantive or original evidence against a party who was not present or represented (see 4A Moore's Federal Practice, Sec. 32.02 and cases therein cited). Since E & H was not present, the transcripts are inadmissible on that ground alone.

Even if E & H had been present, however, the remainder of Rule 32(a) sets further restrictions on the use of a deposition. Since Mr. Rauch declined to testify at the trial, invoking his constitutional privileges, the exception for impeachment under Rule 32(a)(1) is not applicable. Moreover, Mr. Rauch was neither dead nor at a greater distance than 100 miles from the place of trial nor is under any infirmity rendering him unable to testify or unavailable for subpoena, so as to satisfy the requirements of Rule 32(a)(3). Moreover, the fact that a witness invokes his constitutional privileges after having testified on deposition is hardly an exceptional circumstance anticipated by Rule 32(a)(3)(E).

Because none of the established rules for the use of these transcripts exists, the Commission is, therefore, required to carve out a special exception for the use of Commission investigative transcripts in the trial on the merits in a court-enforcement proceeding.[7] The court below correctly found that no such special exception exists.

The cases cited by the Commission to support its position that the transcripts were admissible against E & H involved statements of an authorized officer acting on behalf of his employer (see Pan American at Brief, p. 44), or the admission of an accident report made by the party involved immediately following the accident which admitted liability (see Cox, Id.), or a statement confirmed at a deposition where there was a right of cross-examination (see KLM, Brief, p. 45). In the instant case, however, Mr. Rauch, when he testified was not testifying on behalf of his employer, but was clearly adverse to E & H and there was no right of cross-examination. Thus, the cases relied upon by the Commission are inapposite.

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[7] The case of S.E.C. v. Glass Marine Industries, 194 F. Supp. 879 (D. Del. 1961) which deals with the admission of transcripts of corporate officers and counsel does not support such an exception. In Glass Marine, the court permitted the admission of investigative transcripts to determine whether there was a similarity of interest between the officials testifying and the corporation which allegedly violated the Federal Securities Laws, 194 F. Supp. at 884. In the instant case, E & H's interest are unquestionably adverse to those of the defendant Rauch.

The court cited as an additional reason for denying admission of the transcripts the fact that the use of the transcripts must be governed by the rules of evidence surrounding a trial on the merits. It is respectfully submitted that the transcripts in question do not constitute admissible evidence under such standards.

Under Rule 65(a)(2) of the Federal Rules of Civil Procedure permitting the consolidation of a hearing on a preliminary injunction with the trial on the merits, the evidence received on an application for a preliminary injunction which may become part of the record on the trial, even in the absence of such consolidation, is restricted to evidence which "would be admissible upon the trial of the merits". The use of this procedure in S.E.C. enforcement proceedings has recently been recognized by the United States District Court to be appropriate, especially where the evidence offered on the application will be relevant to the merits and "will be presented in such form as to qualify for admission on the trial proper," 1966 Advisory Committee's Note to Revised Rule 65, 39 F.R.D., 124 (1966), cited in S.E.C. v. North American Research and Development Corp., 59 F.R.D. 111 at 114 (S.D.N.Y. 1972).

In the instant case, as noted above, the transcripts would not be admissible as evidence at a plenary trial and

thus were properly excluded by the District Court. However, as noted above, even if admitted, the Commission has failed to show the manner in which the transcripts would have been adverse to E & H's position. Thus, the admissibility of the transcripts as an abstract matter need not necessarily be determined on this appeal.

CONCLUSION

The Commission failed to establish in the Court below any justification for relief against E & H. Based upon the uncontroverted facts upon which the findings of the Court below were made, it is clear that no such right to relief exists. Similarly the theory which seeks to impose absolute liability upon E & H for the unauthorized acts of its registered representatives is contrary to statute, case law, fundamental fairness and common sense.

By reason of the foregoing the judgment of the District Court dismissing the complaint as to E & H should in all respects be affirmed.

Respectfully submitted,

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